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June 22, 1994

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JUN 22 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

BY HAND

William F. Caton, Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Re: PP Docket No. 93-253 Ex Parte Presentation; Nalebuff Comments on Bidding Credits

Dear Mr. Caton:

Attached is a short memorandum from Professor Barry Nalebuff of the Yale School of Organization and Management regarding Commission efforts to prevent unjust enrichment in the context of implementing bidding credits for Designated Entities. Professor Nalebuff's resume was included with his earlier submissions on behalf of Bell Atlantic Personal Communications, Inc. ("Bell Atlantic") in this docket.

The attached piece is short and self-explanatory. Professor Nalebuff has identified a conceptual flaw with respect to the way fees are charged for unjust enrichment in the event that a DE transfers its license to a non-DE or otherwise loses its DE status. He then offers a simple solution as to how the unjust enrichment formula can be adjusted to solve the problem.

Should you have any questions regarding this submission, please do not hesitate to contact me.

Very truly yours,

James H. Barker
of LATHAM & WATKINS

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Comments on Designated Entity Bidding Credits

Barry Nalebuff
Yale School of Management
135 Prospect St.
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I believe that the current proposed Designated Entity (DE) bidding credit scheme has an important conceptual flaw regarding the way in which fees are charged for undue enrichment. In my brief comments, I illustrate the problem and offer a simple solution.

In the PCS auction, there is a real potential for DE (or DE consortia) to bid against each other and thereby dissipate the bidding credit. This would not be a problem except for the undue enrichment clause. This clause would require DEs who transfer or assign their licenses to non-DEs (or who take other action that would result in the loss of their DE status) to reimburse the government for the full value of the 25% DE bidding credit.[1]

I believe that the unjust enrichment rule requires a simple but important modification. *In the event of a license transfer, bidders should be charged for the DE credit only to the extent that it provided value in the auction. Just because someone gets a 25% bidding credit does not mean that it resulted it a 25% savings (so that they should pay a 25% penalty if the license is sold).* The economic value of the DE credit is only the extent to which it allows a bidder to win a license that he or she would otherwise not have won. To the extent that the bidding credit has no effect on the outcome, it has no economic value and therefore there should be no penalty associated with license transfers.

Consider the case with three bidders, two Designated Entities and one non DE bidder.

	Bid	True Cost of Bid
DE #1	125	100
DE #2	110	88
Non DE Bidder	90	90

Note: For simplicity, I consider the case where there is only one license in one region being auctioned. The principles apply directly to all the more general cases.

[1] *Second Report and Order*, PP Docket No. 93-253, at ¶ 263.

In the above example, DE #1 wins the auction with a bid of 125. However, it would not be fair to charge this DE with a 25% undue enrichment penalty if the person were to sell the license. *The reason is that absent the DE preferences, the same DE would have won the auction with a bid of 100.* The entire DE credit was effectively competed away by the competition between DE #1 and DE #2.

The analysis changes if we switch the positions of DE #2 and the non-DE bidder.

	Bid	True Cost of Bid
DE #1	125	100
DE #2	90	76
Non DE Bidder	110	110

Now, absent the DE credit, the DE #1 would not have won the bidding. The credit was effectively worth $10 to the bidder as it allowed a bid with true cost of 100 to beat a non-DE bid of 110. In this case, the true subsidy is $10 --- this is the relevant undue enrichment fee that we use as a baseline for any penalty charges. If the penalty were to be halved after 1 year then we would only charge $5 for a transfer by DE #1 after 12 months in this example.

The general principle to calculate the DE subsidy is as follows. First, the only relevant case is when a DE wins. In that event, take the true cost of the highest losing bid. The relevant subsidy is

[Highest true cost among losing bids] - [True cost of winning DE bid]. **(1)**

In the second example, the highest true cost among the losing bids was 110 and so the subsidy is $10. However, in our first example, the highest true cost was 90 and thus the subsidy was -$10. In this latter case, there is no subsidy, so we call the amount zero. [Note whenever this subsidy is negative, we call it zero.] The DE is getting a bonus only to the extent that the true cost paid by the DE would not have won the bidding. Along with each of the high bids, the FCC could also announce the effective DE subsidy (or transfer penalty).

Finally, we could extend this result to also include the cases where firms bidding in coalitions with a DE get a partial bidding credit. For example, if a consortium gets a 10% premium added to its bid, then the relevant subsidy is still

[Highest true cost among losing bids] - [True cost of winning DE bid].

However, now the true cost of the winning DE bid is 91% of the bid rather than 80%. If DE credits are widely available as part of a consortium, I expect that the relevant subsidy will be significantly less than the DE bidding credit.

In conclusion, this is a simple problem with a simple solution. We should correct the undue enrichment formula to take account of the true economic value of the DE credit. Fortunately, this economic valuation is an objective number and can be calculated as part of a simple formula (equation 1). DEs who transfer or assign their licenses to non-DEs (or who take other action that would result in the loss of their DE status) should reimburse the government for the economic value of the DE bidding credit, where the economic value is only the extent to which the highest true payment offered by a losing bidder would have been above the true payment made by the winning DE bid.